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ECONOMICS

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Are Sanctions Saving Russia?

MOSCOW – The economic sanctions imposed on Russia by the West in March 2014 have undoubtedly been painful. But they have so far failed to achieve their goal of weakening Russian President Vladimir Putin's position. In fact, they may have had the opposite effect, leaving Russia – and its president – even stronger than before.

To be sure, Russian GDP, which grew modestly in 2014, contracted by 4.6% in annual terms in the second quarter of this year. The ruble lost more than half of its US dollar value in the second half of last year, fueling inflation, which increased by 15.6% year on year in July. And Russia has lost about $100 billion in trade with European Union countries.

But inflation now seems to have peaked, and the effects of the drop in oil and gas prices were mitigated by the US dollar's appreciation, so that the value of Russia's

foreign reserves actually increased, reaching $362 billion in June (13% of which is in gold). The trade losses with the EU have hit the likes of Bavarian dairy farmers and German industrial exporters particularly hard. And despite some belt-tightening in Russia, Putin is more popular than ever.

The rationale behind economic sanctions is straightforward: free trade and free markets deliver growth (and thus political support for the government), whereas restrictions choke off growth (and thus erode support for the government). This emphasis on free trade and free markets was a central tenet of nineteenth-century British classical economics. It remains a core message of today's dominant neoclassical school – embodied in the so-called "Washington Consensus," adopted across the world under the International Monetary Fund's advice – which claims that the key to economic development is to open up, deregulate, liberalize, and privatize.

But the theory is fundamentally flawed. No economic power has developed based solely on *laissez-faire* policies. The economic rise of the United Kingdom, for example, was heavily dependent on strategic protection, industrial policy, tariffs, and non-tariff trade barriers.

The UK's industrial prowess originated with the textile industry. The country's leaders realized that the export of raw materials, mainly wool, would be inadequate to spur economic development. For that, England would have to move up the value-added ladder, by importing raw materials and exporting finished goods.

So England's leaders devised an industrial policy, which entailed bringing in Flemish textile weavers to provide know-how to British firms. Moreover, they erected trade barriers: By banning the export of raw wool and the import of finished wool products, Indian textiles, which were often superior and cheaper, could not compete with domestic output. They adopted navigation laws that restricted foreign ships' access to British ports, and even enacted a demand-boosting law requiring the dead to be buried in a wool shroud. Ultimately, the mechanization of the textile industry ushered in the Industrial Revolution, and mass production and exports underpinned the development of the world's largest maritime fleet.

In the mid-nineteenth century, the German-American economist Friedrich List highlighted the role that such policies played in the UK's development. In line with his

advice, the United States, Germany, and Japan employed judicious trade protection and industrial policies, while working actively to support nascent sectors – a strategy that enabled them to develop rapidly and even overtake Britain.

Restrictions also proved effective to spur economic development: In 1812, when the UK declared war and imposed a trade embargo on the US, import substitution caused American manufacturing to flourish. When the embargo was lifted and trade tariffs were reduced, US manufacturing floundered – until 1828, when new British tariffs boosted US manufacturing again. Likewise, during World War I, a British trade embargo fueled the creation of high-tech industries in Germany to develop alternatives.

Of course, embargoes can have a devastating effect when a country lacks the resources needed for import substitution. That is why economic sanctions were so damaging for Iran.

But, for a country like Russia, with its abundant natural resources, technological expertise, and skilled workforce, sanctions can have the opposite effect. The Soviet Union struggled to capitalize on these factors, owing to communism's weak incentive structure. Today, by contrast, Russia has a capitalist system that offers considerable benefits to those who adapt best to current constraints.

In short, Russia has all it needs to thrive, despite – or because of – the sanctions. But turning opportunity into reality requires Russia to pursue an economic transformation.

Neoclassical trade theory is based on the concept of comparative advantage: countries should capitalize on their relative strengths, from technological prowess to resource endowments. But, as English leaders knew, and as the experience of many African and Latin American countries has shown, simply exporting raw materials is inadequate to propel development. Historically, the most effective development policy has centered on government intervention to establish higher-value-added domestic industries. In previous decades, Japan, Taiwan, South Korea, and China have all taken this path.

For Russia, moving up the value-added ladder should not be difficult; it has everything it needs to manufacture the finished products that it previously imported. In fact,

import substitution has already increased productivity in several key sectors: engineering, petrochemicals, light industry, pharmaceuticals, and agriculture. Annual exports of high-value-added goods rose by 6% in the first quarter of this year.

Furthermore, Russia has accelerated cooperation with the other BRICS economies (Brazil, India, China, and South Africa), and Putin recently announced ambitious plans to boost domestic demand.

The West's sanctions against Russia may not only fail to change the Ukraine situation; they may well spur the country's long-awaited structural transformation. If Russia successfully replicates the credit-guidance regime used by East Asia's economies, while increasing managerial efficiency, another economic miracle is possible.

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